

## 1.2.1 The Corporate Context of Treasury

### Exercise<sup>1</sup>

<b>Unit:</b>	Unit 1 – Treasury Strategy
<b>Module:</b>	Module 1 – Corporate strategy
<b>Date:</b>	1 September 2014
<b>Summary:</b>	An exercise to investigate the overall objective and strategy of a quoted company and to see how financial and treasury policy align to help that.
<b>Keywords:</b>	exposure, budget, policy, leverage, headroom, cashflows, debt servicing, foreign exchange exposure, Annual Report, preliminary statement, listing authority, equity analysts, trading statement

#### ***Background to the exercise***

##### **Why is context important for the treasurer?**

It can be argued that a group treasurer doesn't really need to understand the business. The level of debt could be based on the corporate plan and any risk management largely limited to accounting exposures. Conglomerates have been run in this fashion with a remote Head Office not wanting to be "contaminated" by understanding the issues faced by operating units – it is the operating unit's job to deliver the budget. With a sufficiently large number of (relatively small) operating units, the portfolio effect probably makes this a viable approach, more so as operating units are under pressure to deliver their budgets. In an environment where budgets are relatively conservative, so the actual operating unit results tend to exceed budget, then the overall performance will easily accommodate the one or two which fail to achieve their budget. Such companies have clearly been bankable in the past. However, another approach to budgets is that they are aspirational, in which case there is more risk to the overall delivery of the consolidated budget.

A treasurer might equally take the view that understanding the business "isn't his job". That's for the operating management and strategic / financial planning teams. The treasurer simply finances the result. As long as he is well briefed, he can explain the issues to potential financiers and / or involve the relevant personnel to close the deal. Equally, the treasurer just needs to keep financial risks within agreed policy limits without much thought to how such exposures arise.

So, does this mean that the treasurer doesn't need to understand the business? In both the above scenarios, someone has understood the business sufficiently to produce the plans, etc used by treasury – this person just doesn't work in treasury. This separation is probably a function of company size and the level of indebtedness. Functions within larger organisations will inevitably be carried out by different work groups. Additionally, in

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<sup>1</sup> Included in this exercise is an activity requiring you to post in the online forum. This activity is indicated by the  icon. You are expected to post forum exercises to the appropriate forum within the two-week timeframe of the module. Please see the study timetable for reference.

companies with low leverage, understanding the business's cashflows isn't as critical as in the more highly geared case.

Let's look at some illustrative examples.

### **Example 1: Headroom**

The treasurer has based the company's borrowing requirements on the 3-year corporate plan and now needs to add sufficient headroom for under- or over-performance, etc. What level of facility headroom is appropriate?

Experience helps, and it is important to remember that the treasurer does not work within a vacuum, and will usually be one part of the business's financial team. If the business isn't too highly geared, past experience might show that it is appropriate to simply add an absolute or percentage contingency. Most treasurers and their finance directors will err on the side of caution, particularly after the credit crisis starting in 2007, and aim to arrange larger facilities rather than smaller if this is possible. Clearly this may be difficult if gearing is high and/or credit conditions are difficult.

What factors might the treasurer consider?

Seasonality is important. The treasurer should have some idea of this from the budget (which will probably have monthly data), but allowance will still need to be made for intra-month variation and timing-differences. This will require knowledge of the group's businesses and their cash flow profiles.

The effect of under-performance on cashflows is also very important. The financial planning team will probably have modelled this to some extent, although their focus is more likely to be profits or earnings. The treasurer needs to understand the drivers of cash flow, how they impact cash, and hence their impact on lending ratios and possibly ratings. Fortunately, the financial planning system will probably output cashflow data as well. However, the treasurer really needs to know which factors affect cashflows together with their sensitivity and this is unlikely to be the focus of the financial planning team. Having established which factors affect cashflows most significantly, the treasurer should then be able to model appropriate scenarios. However, the treasurer can only do this effectively if he models realistic scenarios and to do this he needs to understand the businesses which comprise the group.

The effect of over-performance on cashflows is equally important. Although over-performance usually implies improved cashflows, this is not universally true, and the treasurer needs to be aware of circumstances where this is the case. For instance, the business may be fast growing and capital intensive, or a profitable business which is overtrading and runs out of cash for working capital purposes.

Remember too that the treasurer also has to explain these requirements to potential lenders. Although this aspect may be undertaken by or in conjunction with the Finance Director, it is nevertheless an aspect of treasury. The treasurer needs to explain what is driving the cashflows and how accounting performance translates into debt servicing and repayment.

**Example 2: Embedded foreign exchange**

A German based division of an engineering group manufactures and sells fuel tanks to a French based car manufacturer. This comprises 75% of its business by value. The division imports fuel pumps from Japan and pays for these in Euros. The fuel pumps comprise over 50% of the cost of the fuel tanks. All other raw materials and costs are also priced in Euros. As all transactions are in Euros the division does not report any FX exposures to treasury.

Prima facie, there is no FX exposure to manage as far as the central treasury is concerned. All the division's transactions are in Euros. But is this in fact correct? It might be that the component price is fixed for the year and the division has budgeted on this basis. On the other hand, the price might depend on the EUR / JPY spot rate at the time of supply from Japan leaving the division fully exposed to the EUR / JPY exchange rate. Without talking to the division, central treasury has no idea. In this instance, the division had negotiated a half-way house. The component price was fixed in Yen terms and in Euro terms for the month ahead unless the current spot price in Euro was 10% higher or lower at the start of the month, when it adjusted to the new level. The intention was to fix the price in Euro terms and this is what the division thought it had done. The outcome was very different and impossible to hedge effectively with vanilla instruments.

These simple examples illustrate how a treasurer will benefit from a proper understanding of the business. In fact, this understanding is fundamental to effective treasury management as we shall see as the course progresses.

**Forum exercise #1:****Understanding the business in my firm<sup>2</sup>**

Create a new post in the *Forum exercise from 1.2.1 Corporate context of treasury* category with the title, U1/M1/1.2.1/Business Understanding/[Your name] /[Company Name].

Explain what happens in the firm you work for; in treasury how much emphasis is placed on understanding the business? Cite examples, if any, where a fuller understanding of the business of the business has led to superior outcomes.

**Yule Catto case exercise****The annual report and other financial information**

In our quest to understand the business of a company, a good place to start is the publicly available financial information produced by companies.

Quoted companies publish an audited Annual Report together with less detailed information on a quarterly or half-yearly basis; the requirements vary by jurisdiction and also by the rules of any quoted securities (e.g. some bond issues require quarterly reporting). Unquoted

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companies rarely publish more information than the bare minimum legally required, and that as late as possible. It is unlikely that there will be financial information on their website and such information would have to be sourced from the relevant filing authority, e.g. Companies House in the UK, SEC EDGAR in the US.

Note however that quoted companies announce their annual results before the Annual Report is published. In the UK this is generally referred to as a Preliminary Statement and contains the main financial statements, key accounting notes and executive reviews of the business. This is issued to the listing authority and is usually followed by a presentation to key shareholders and equity analysts. The company will normally also issue a forward looking Trading Statement. If the preliminary results and trading statement are not in line with the market's expectations, the company's share price will react according to the perceived discrepancy between the actual and the expectation. Note that the share price reaction may not seem logical, and the initial reaction is likely to be followed by further movement (in either direction) as the market comes to terms with the announcement.

In addition, most quoted companies also maintain websites where they provide an array of additional data about their commercial activities.

### **Yule Catto case exercise**

In this exercise we try and attempt to identify various policies and objectives based on a company's own published financial information.

Review the following documents:

- Yule Catto 2010 Annual Report
- Yule Catto 2010 Preliminary Results
- Yule Catto 2010 Results Presentation
- Extracts from Yule Catto's press release of 13 December 2010. Rights issue and acquisition of Polymer Latex

Then, using the framework on the pro-forma, make a note of any relevant and significant issues that can be matched to the various topic headings of the pro-forma:

1. Overall business objective
2. Business policy/corporate strategy
3. Financial policy and objectives
4. Treasury policy and organisation
5. Organisation structure

This is a difficult exercise in that it requires judgment to select the most important issues under each heading from a great mass of detail. But the skills so developed will stand you in good stead in your professional life!

Note that you are not concerned in this exercise with the substantive content of the financial statements.

Note also that you are not expected to review any material issued by Yule Catto since the 2010 Annual Report (the exercise is 'frozen' at this point in time). In fact the company is now called Synthomer plc following the acquisition and consequent changes.

You will be looking at Yule Catto again before the end of this course so any work you do here will stand you in good stead for future exercises.



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## Forum exercise #2: Annual reports<sup>3</sup>

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Create a new post in the *Forum exercise from 1.2.1 Corporate context of treasury (annual reports)* category with the title, U1/M1/1.2.1/Annual Reports/[Your name] /[Company Name].

Comment on the quality of information available in the Annual Report, Preliminary Statement and Results Presentation as a source for providing data on the items in the pro forma.

How useful do you think Annual Reports [and presentations] are to treasurers? What might be gained with further access to internal data? Does simply knowing that Yule Catto is in the chemicals sector say more than is said in the accounts? What does this mean for the value of broker reports where the analyst has good industry knowledge?

Would it have been more helpful to access Yule Catto's website? If yes, explain why. See [www.yulecatto.com](http://www.yulecatto.com) (or [www.synthomer.com](http://www.synthomer.com)).

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